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Redefining the EU-China economic partnership: beyond reciprocity lies strategy

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The EU-China economic relationship is transitioning to a new era. Years of soaring Chinese investments in Europe are increasingly met with unease by EU leaders. Beijing's influence on the activities of its global economic actors resulted in economic security concerns about critical infrastructure and national security on the continent. A hectic debate about Chinese technology companies and a new EU regulation on a common investment screening regime are evidence of an ongoing policy response to perceived growing risks from economic interdependence.

Europe is right to acknowledge these risks. But Europe is also alarmingly divided. Lacking common priorities for action makes individual policies vulnerable and insufficient. A new EU strategy on China must start at home. Of course, Member States' political expediency is the Union's eternal handicap. But this policy brief offers three lines of action in which policy reform can support Europe's resilience and reinforce the foundation of an EU strategy on China: (1) Follow the money; (2) invest in substance; and (3) step up in your neighbourhood.

THE RISE OF ECONOMIC SECURITY

Although 2018 saw Foreign Direct Investment (FDI) from China in Europe fall by as much as 70% compared to the previous record year, Chinese investment stakes in Europe remained resilient. More than €17 billion of pending transactions at the beginning of 2019 substantiate this trend.[1] A robust domestic R&D environment, advanced high-tech industries, and abundant industrial know-how for key technologies made Germany, France, Italy, and the UK the leading recipients of Chinese FDI in the 21st century.[2]

But the connection to China's 2015 industrial strategy Made in China 2025 (MIC2025) is conspicuous. For instance: one study found that between 2014 and 2017, 64% of Chinese corporate investments above a 10% stake in German companies were in sectors prioritised by MIC2025.[3] Investments are also predominantly geared towards take-overs of companies, which allows for easier acquisition of the relevant know-how. Since 2014, more than 90% of Chinese investments in the EU have been acquisitions, another report finds.[4] Additionally, in 2017 68% of investments were undertaken by state-owned enterprises (SOEs), whose connection to the Communist Party (CCP) is often inextricable.

Alarm bells are ringing. The close link between the Chinese state and Chinese commercial actors is seen with mistrust by European officials, worrying about insufficient coping instruments of Europe's market economies. Economic security concerns about critical infrastructure and national security have been rising in this context. The 2017 US National Security Strategy expresses this concept in a most ostensive manner: "economic security is national security."[5] The lines between what is considered protection and what protectionism are blurring – also in Europe.[6]

'Pour l'amour de Dieu, ne laissons pas les querelles de pêcheurs dégénérer en querelles de nations', the Duc de Choiseul, Minister to Louis XV, pled to the Board of Trade in 1763, concerned about securitisation of commercial fishing.[7] In some way, the fishermen of the 18th century are today's advanced technology producers and national champions, which are increasingly aligned with the national interest or even national security.[8] French Finance Minister Bruno Le Maire warned of the dangers of 'looted' French assets,[9] while former Italian trade minister Carlo Calenda warned Europe not to 'unilaterally disarm' against China.[10] National security considerations, not economic efficiency, are increasingly challenging the previous balance between the norms. As a result, the list of national security and critical infrastructure discussions in Europe is growing.[11]

The EU-China economic partnership is caught amid the growing saliency of economic security. But not without good reason. Economic exchange can generate asymmetries in which power relations dominate. Economic interdependence simply is not power neutral. It invites states to exert political or strategic influence through asymmetrical networks.[12] Europe is right to acknowledge these risks. Policy reform aimed at strengthening resilience against these risks is key for a balanced EU-China partnership and demand prioritisation.

A FIRST RESPONSE

A policy response has been ongoing. The most important one among them has been the adoption or reform of national investment screening regimes in Member States. These regulations are an expression of the rise of the economic security norm. When states use interdependence for strategic ends, other states are likely to start considering them in strategic terms too.[13] Take Germany: Faced with a wave of Chinese investments, Berlin reformed the national FDI screening regime twice within only 18 months, responding directly to attempted take-overs of critical infrastructure. Germany now also considers the media industry to be critical infrastructure, for instance.

At the EU level, legislation to this end was formally adopted this month. The regulation allows taking a closer look at foreign investments in cases concerning critical infrastructure and cutting-edge technology.[14] Member States remain sovereign in their decision to intervene or not but are required to inform the Commission, which may issue advisory opinions if it considers potential security or public order concerns.

The regulation exemplifies the thin line between protection and protectionism. Free-market purists fear that the vague definitional scope of 'national security' and 'public order' in the agreed text will invite unfair discrimination of Chinese or foreign investors based on political mantras. Protectionism in disguise. The security community meanwhile laments the horse blinders mentality of commercial actors. Commission advisory opinions, they assert, may simply not be enough to offset the potential risks of China's steep economic engagement.[15]

European governments too were split on the policy. Two camps of Member States, with changing positions between them (such as Italy which opposed the EU regulation under its new government), eventually agreed on the framework. Given initially strong differences, the regulation was a legislative success and marks an important instrument towards closing the gaps of asymmetrical interdependence. But the lowest-common-denominator approach is vulnerable. To balance the EU-China economic partnership for the next decade, a new EU strategy on China is indispensable: a strategy which reinforces the foundation of EU coherence and which addresses the gaps through which it can be undermined. In short, it must go beyond repeated calls for reciprocity.

ONE EUROPE, MANY STRATEGIES?

To be sure, different contours of an EU strategy on China exist: the 2016 Joint Communication on 'Elements for a new EU strategy on China', followed by a 2017 Council Conclusion, the 2018 European Parliament 'Resolution on the state of EU-China relations', and, to some degree, the 2018 'EU Connectivity strategy' represent the state-of-the-art. All are heavy on the economic side of the relationship.

'Reciprocity' and a 'level-playing field' is the most important jargon across these documents. In simple terms, they call for improved market access for European companies in China (e.g. in restricted sectors such as public procurement, digital services, telecommunications, financial services). They also call for China to stop discriminatory practices (e.g. non-transparent subsidy regimes, tech transfers, administrative procedures).

The negotiation of a bilateral investment treaty, the EU-China Comprehensive Agreement on Investment (CAI), is one of the primary policy instruments to achieve these goals. Started in 2012, sluggish negotiations are still ongoing. The differences to bridge are wide. Upon conclusion, the CAI is hoped to achieve its goals of improving market access and to regulate the nature of SOEs. But it requires to go beyond any existing approaches taken by the EU (e.g. EU-Vietnam trade agreement). European leaders should not put all their hopes on a sweeping success of the CAI.

Other measures are necessary to work towards a sustainable long-term balance in the economic relationship. For instance, a watershed document of the German manufacturing industries' association (BDI) in early 2019 urged policy-makers to increase the resilience to threats posed by China's state-dominated economy. The group proposed a policy reform package but also warned German companies to diversify their export markets away from China due to "excessive dependence." [17] This is significant, as it indicates that also the business community is concerned about economic security risks posed by China.

Beyond calls for reciprocity in the EU-China relationship lies the necessity to field a strategy which acknowledges that European cohesion is a prerequisite for action. Individual Member States' political expediency chips away at the comprehensiveness of a common policy focusing on substance. A state visit by German Finance Minister Scholz in Beijing mid-January 2019, in which he concluded market access and cooperation agreements for German financial and insurance industries, highlighted this problematic dynamic: there seems to be no coordinated position among Member States and institutions which sets priorities and requires coordination among all actors when engaging with China.

The 16+1 framework[18] – or, as some prefer to call it, the 1+16, to highlight the power balance more appropriately – illustrates the other side of this dilemma. Beijing's economic relationship with the 16 is dauntingly asymmetrical. Next to economic considerations, including a link to the lucrative Belt & Road Initiative (BRI), the platform serves as foreign policy tool and an avenue for influence. Economic interdependence is simply not power neutral.

Beijing has already gained political capital for comparatively little economic investment among many of its members. At the same time, several of the 16 also have political interest, for instance to use the platform as a bargaining chip vis-à-vis Brussels.[20]

This is not true for all members. Initially widespread euphoria about the 16+1 by now diluted into different camps, with some EU Member States such as Poland having grown more sceptical of the framework's benefits and about its risks.[21] Others, such as Orban's Hungarian government and the Czech Republic under President Zeman, remain hopeful for major political and economic gains. Non-EU Member States, with large financing needs, remain largely positive towards the platform.[22]

The strategic dimension of the 16+1 thus goes both ways: The asymmetric interdependence of the relationship makes the platform a foreign policy tool for China. Beijing may for instance use the format as a bargaining chip vis-à-vis the EU, offering less intensive 16+1 engagement in return for political support on other portfolios (China is suspected to have tried this strategy).[23] At the same time, some 16+1 members, both EU and non-EU, may use their participation in the platform as bargaining chip vis-à-vis Brussels.

EU Members have many different interests towards Beijing, both commercial and political. This is no news per se, it remains the Union's Achilles heel especially in its Common Foreign and Security Policy (CFSP). Asymmetrical interdependence may expose these cleavages and exploit them. For every country China wants to influence, there is also always a country which plays along. We can hardly blame China for leveraging these gaps. But the EU must focus on closing them. Policies must be designed to compete with third powers in those key nodes in which asymmetrical interdependence may invite foreign influence – both inside and outside the Union borders.

THE WAY FORWARD

1.Follow the Money

First, the EU must direct its economic activity to strategically important locations.

Europe's strategically important locations are those economic nodes where third states can leverage their interdependencies, both inside and outside the Union borders. This does not mean that the EU should strive to emulate a state-capitalist system in disregard of market-based rationales for investments. Yet, equally, EU economic instruments must be made fit for a new Geoeconomic era in which states increasingly leverage economic instruments for strategic advantages. The EU must find its own path, of course: defending its liberal market economic model, while providing strategic incentives and frameworks which work to its benefit.

The immediate EU neighbourhood, especially the accession countries in the Western Balkan, represents an essential pillar in the Union's resilience against outside influence which may undermine coherence. This is to some degree recognised in the EU Connectivity Strategy. But it also constitutes a fundamental building block for a new EU strategy on China. If we want to be a credible actor with our partners, we must close the gaps in our immediate neighbourhood. This link must be explicit in an EU strategy on China.

In the Western Balkans the EU is competing for its regulatory and political influence in the region. Finance offers the broadest avenue for influence in the infrastructure project development cycle. Without the protection of EU regulatory standards through a strong legal frame, the Union must first and foremost convince local partners of committing to uphold sustainable regulatory standards for instance when tendering for large infrastructure projects.

A tedious task, as local authorities often only submit to standards à la carte and the EU lacks strong conditional strings in its accession relationship.[24]

Partners and the purse are important for competition in the region. The multilateral European Bank for Reconstruction and Development (EBRD) could act as a pillar for economic cooperation through which Chinese and local investment standards ideally align with EU and global regulatory standards. The EU is already the biggest donor to the bank, providing grants through various external investment instruments.[25] The EU's capital contribution to the EBRD should be more narrowly streamlined with other investment instruments, including the European Investment Bank (EIB) and national lenders.

The Commission acknowledged this importance: the proposal for a new external investment architecture under the next EU budget (the Multiannual Financial Framework (MFF)), with simplified, more streamline external instruments and overall more financial firepower (30% increase) could be a significant step. An investment framework for external action of up to €60bln was also tabled. It is up to the national governments to act on these proposals in the MFF negotiations.

Within EU borders, the 2014 Investment Plan for Europe (IPE), with as its primary pillar the European Fund for Strategic Investments (EFSI), could also be more closely streamlined by linking it to the *EU Connectivity strategy* for instance. This could act as an important bridge between internal and external investment flows and pre-empt deepening asymmetric interdependencies at the borders of the Union

Mobilising private capital is of course key for EU investment instruments. By reduing the risks for private investors, the Union's instruments can unlock big multiplier on their investment. For quantitative reasons alone, private capital is necessary.

But that does not mean the debate about sovereign investment instruments should be buried. Quite the opposite. Recent experiences in safeguarding the Iran Nuclear Deal (JCPOA)[26] and the subsequent development of a Special Purpose Vehicle (SPV) demonstrate the importance of investment flexibility for strategic purposes which may only be guaranteed by sovereign instruments. Debating such emergency measure instruments in anticipation of similar events is necessary.

Similarly, a Domestic Investment Facility could step in when EU strategic sectors (critical infrastructure) are at risk of take-over and no private investor can be found. The take-over of German robotics firm KUKA by the Chinese Midea Group in 2016 re-opened this debate. In 2018, German state bank KfW successfully fended of a Chinese take-over of 50Hertz, a high-voltage network operator. Germany's new industrial strategy 2030, released this month, calls for the introduction of such policy instruments.[27] This is a legitimate debate and must be discussed at the European level – and not only at the level of economic efficiency.

Additionally, the financial firepower as well as the lending mandate of the EIB could be re-negotiated by Member States. 2018 already saw a strategic turn for the EIB lending mandate in response to the US re-imposition of its sanctions regime on Iran. In all too familiar EU *ad hocery*, Iran became eligible to receive EIB financing. The bank's commercial activities were streamlined with the Union's strategic interests: to safeguard the JCPOA. Anticipation of similar events is indispensable. Streamlining the EIB mandate more closely with the Connectivity Strategy for instance could allow for more flexibility in the future.

The looming Brexit may open the necessary space to address these questions. The EIB has already moved into Member States' diplomatic cross-hairs. Capital increases, compensating the UK's share, as well as governance reform are under discussion. Diplomats should remember the lessons learned with regards to the possible role of the bank in supporting strategic goals.

2. Invest in substance

Second, the EU must invest in sectoral dialogues with relevant substantive collaboration.

There exists a myriad of more than 80 dialogue formats between the two – from research & innovation, competition policy, trade, business, energy, customs, maritime, and tourism, to name but a few which were identified in last year's 20th EU-China Summit Joint Statement.[28] As both parties like to affirm, the strategic partnership is comprehensive.

And yet comprehensiveness does not necessarily give indication on the importance of individual formats. High-level summits are important. But substantive collaboration at the technical level is even more crucial. High-level summits are the body of the car body, which cannot drive without its engine: substantive collaboration.

Not all formats of cooperation are equally important. Priorities must be defined and given prominence. The EU's priorities lie in those formats addressing the avenues for influence.
Infrastructure development represents such an avenue.[29] The 2015 EU-China Connectivity Platform is an important tool aimed to create synergies between transport infrastructure development policies of the two partners, namely the Trans-European Transport Network (TEN-T) framework and the BRI. But the success of the platform has been limited. Only three meetings so far[30] and somewhat dissatisfied EU officials stand in contrast to its ambitious agenda a few years ago.

Yet the platform's significance remains high. The EU should spend political capital to increase its substantial scope (energy, digital) and bind other partners such as the US and Japan into the platform. This is already a goal of the Connectivity Strategy, but should be a priority action point in the EU-China economic partnership.

3. Step up in your neighbourhood

Lastly, the EU must step up in its neighbourhood and make a difference where it is expected to do so.

It is not only about money. This has become painfully obvious in the Western Balkans. Despite the EU accounting for 75% of FDI in Serbia for instance, public support for membership dropped from over 70% in 2003 to less than 30% in 2017. Unfortunately, a growing trend in the region. Meanwhile, Chinese and Russian recognition has been soaring in the region in past years, despite comparatively little economic investments.

A positive communication agenda is an important instrument to support economic efforts. The EU is not least competing with China's development approach. BRI projects are skilfully announced across Chinese-influenced media outlets and are well coordinated with the political platform of the 16+1. The notion of huayuquan (话语权) – to speak with authority, guide debate, and set the parameters of acceptable discourse – has become an important discursive tool. Beijing's has mastered public diplomacy through different channels.[32]

With new players in the region, the EU must rethink its engagement. Above all, EU leaders must realise that they are competing for influence in a region previously regarded as a largely exclusive EU playground, which could be managed only by its accession instruments. This strategy has been proven insufficient.

A new, convincing narrative on all levels: national and local government and civil society is necessary. Above all, a credible path to accession must be clearly outlined. Technical aspects of accession are important. But without full political commitment, Europe is undermining its influence.

Bottom-up approaches are equally important. The EEAS has set up, a 'Stratcom Western-Balkans Task Force' in 2017, promoting fact-based narratives about the EU. While the main tasks of Stratcom focus on dispelling myths, disinformation, and propaganda, a positive narrative on economic development is equally important in building resilience.

The EU's principles of connectivity, as defined in the Connectivity Strategy, are contested by China's economic role in the region. A more vigorous bottom-up diffusion of these EU principles could be approached by linking up the Connectivity Strategy with the Stratcom Western-Balkans Task Force. This could allow for a more concerted effort by local EU delegations, national embassies, and the Stratcom Task Force to implement the Connectivity Strategy and remain competitive.

Partnerships, both private and public, are key for increasing local engagement in projects and gain multiplier effect on public diplomacy efforts. The US, Japan, and others have put forward their own connectivity strategies. It is mandatory for the EU to link up their partners efforts as quickly as possible.

CONCLUSION

The EU is in the middle of a Great Power struggle: towards the West, US pressure on Europe to de-couple from Chinese interdependence is mounting; towards the East, Beijing's deep and asymmetrical economic engagement caught the EU on the wrong foot and put it in a defensive position in defining the content of the economic partnership. How Europe will be able to position itself between the unfolding Great Power competition may be its greatest challenge in the coming decade.

But diplomatic mastery alone will not suffice. To remain the desired stabilising force between the two powers, the Union must strengthen its foundations and field a coordinated strategy towards them. Without swift action, European states risk becoming chess pieces the Great Powers.

There is a window of opportunity with China: the strategic rivalry with the US, a tumbling Chinese economy, and domestic political contestation pushes the CCP to the European table. Will the Europeans agree on what they want and where they want to go? A strong, unified strategy on China is a policy choice taken in European capitals, not in Beijing.

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